Red Means Green: The Disruption of the Statutory Construction Process in *Gustafson* to Harmonize Section 12(2) and Rule 10b-5 Private Liability Actions Under the Federal Securities Laws

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I. INTRODUCTION

Against the backdrop of the stock market crash of 1929 and the Depression,[1] the Securities Act of 1933[2] (hereinafter the 1933 Act) was enacted by Congress primarily to replace the notion of caveat emptor[3] with a system of full disclosure[4] in the case of the offers and sales of securities.[5] Hence, the

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1 James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

2 15 U.S.C. §§ 77a–77aa (1994).

3 Caveat emptor means "buyer beware." BLACK'S LAW DICTIONARY 222 (6th ed. 1990).

4 *See* 1 THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2, at 7 & n.4 (3d ed. 1995).

5 "Security" is defined quite broadly under section 2(1) of the 1933 Act. The statute provides in pertinent part:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1994).

m1933 Act requires the registration of any security being offered to the public,[6] subject to a number of exemptions,[7] and prescribes a process by which

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[6] The disclosure process mandated by section 5 is implemented by preparing and delivering a registration statement and a prospectus. Section 5(a) of the 1933 Act prohibits the sale or delivery of any security without first filing with the SEC a registration statement which has become effective. *See* 15 U.S.C. § 77e(a) (1994). Section 5(b)(1) prohibits the sale of a security by means of a prospectus which does not meet statutory standards contained in section 10. *See* 15 U.S.C. § 77e(b)(1) (1994). Section 5(b)(2) of the 1933 Act prohibits the sale of securities which are not accompanied by a prospectus. *See* 15 U.S.C. § 77e(b)(2) (1994). Furthermore, section 5(c) prohibits the offer of securities for sale before the registration statement is filed. *See* 15 U.S.C. § 77e(c) (1994).

[7] Sections 3 and 4 of the 1933 Act provide exemptions from section 5's registration requirements. *See* HAZEN, *supra* note 4, § 4.1, at 183–86. Section 3(a) exempts from registration the securities of governments (federal and state), charitable organizations, banks, savings and loans, and common carriers, which are regulated under other federal statutes. *See* 15 U.S.C. § 77c(a) (1994). Section 3(b) authorizes the SEC to exempt securities if it finds that registration "is not necessary in the public interest and for the protection of investors by reason of the small amount involved [a $5 million dollar ceiling] or the limited character of the public offering." *See* 15 U.S.C. § 77c(b) (1994).

In Regulation D, the SEC exercised its section 3(b) authority by adopting Rules 504 and 505, and the 4(2) exemption in Rule 506. *See* 17 C.F.R. §§ 230.501 to .506 (1996). Rule 504 exempts from registration any offering in a 12-month period amounting to less than $1,000,000 (decreased by amounts sold in reliance on other exemptions). *See* 17 C.F.R. § 230.504. This exemption is aimed at smaller businesses and is not available to 1934 Act reporting companies. Rule 505 permits a company, including 1934 Act reporting companies, to sell up to $5,000,000 in securities (reduced by amounts sold in reliance on other exemptions) in any 12-month period without registering, provided the sales are to no more than 35 unaccredited investors. *See* 17 C.F.R. § 230.505. Accredited investors are wealthy persons and institutions who are less likely to require government protection in making investment decisions. *See* 15 U.S.C. § 77b(15)(i)–(ii) (1994). SEC Rule 215 defines "accredited investors" as used in section 2(15)(ii) to include several categories. *See* 17 C.F.R. § 230.215 (1996).

Another crucial exemption is the section 3 exemption for wholly intrastate offerings, which applies only to issuers doing business in a state who offer and sell securities only to residents of that same state. *See* 15 U.S.C. § 77c(a)(11) (1994). A single offer of shares for sale to a nonresident will void the exemption. *See, e.g.*, Busch v. Carpenter, 598 F. Supp. 519 (D. Utah 1984), *judgment aff'd in part, rev'd in part*, 827 F.2d 653 (10th Cir. 1987). Congress believed that federal regulation was unnecessary in these situations because of the availability of state regulation and the close proximity of the purchaser to the seller.

In contrast, section 4 exempts specific types of transactions. Perhaps the most important of these is section 4(1), which exempts "transactions by any person other than an issuer, underwriter, or dealer." *See* 15 U.S.C. § 77d(1) (1994). This exemption means that required information must be disseminated to investors in the form of a prospectus.[8]

Sections 11 and 12 of the 1933 Act provide potent private remedies for violations of the Act,[9] and, in addition, the 1933 Act contains a general anti-fraud provision.[10] Section 12(2)[11] provides in pertinent part:

> Any person who offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a)

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once the security is sold to the investing public, the public may trade without any concern about the registration or prospectus delivery requirement of section 5. Section 4(1) therefore exempts these so-called "secondary transactions" from having to meet the requirements of section 5. *See supra* note 6.

Section 4(2), the "private placement" exemption, exempts "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (1994). This exemption for nonpublic offerings by issuers is widely used by both closely held and publicly traded corporations. *See* HAZEN, *supra* note 4, § 4.21, at 250. In order to flesh out the section 4(2) exemption, the SEC promulgated Rule 506 as part of Regulation D. Rule 506 permits all companies to sell an unlimited amount of securities in an issuance if sales are limited to 35 unaccredited investors and an unlimited number of accredited investors. The issuer must reasonably believe that all unaccredited purchasers are "sophisticated" and therefore capable of protecting themselves without the assistance of a registration statement and statutory prospectus. *See* 17 C.F.R. §§ 230.506(b)(2)(i), 230.501(a)-(e) (1996). Accredited investors, on the other hand, are presumed to be sophisticated, although an unsophisticated purchaser may act through a sophisticated purchaser representative. *See* HAZEN, *supra* note 4, § 4.22, at 261. Accordingly, Rule 506 provides a "safe-harbor" for any issuer planning a private offering that satisfies the rule's requirements. *See id.* at 260–66.

[8] Section 10(a)(1) of the 1933 Act states what information must be contained in the "prospectus" given to offerees in compliance with the section 5 mandate. *See* 15 U.S.C. § 77j(a)(1). However, Congress provided a broad statutory definition of the term "prospectus" in section 2(10) of the 1933 Act, which states that "[t]he term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written by radio or television, which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77b(10) (1994).

[9] Section 11 creates a right to damages for a buyer arising from misstatements or omissions in a registration statement. *See* 15 U.S.C. § 77k (1994). Section 12(1) provides for a right of rescission for any sale of an unregistered security where the security was required to be registered under section 5 of the 1933 Act. *See* 15 U.S.C. § 77*l*(1) (1994). Section 12(2) also provides for a right of rescission where the sale is made by means of a false prospectus or oral communication. *See* 15 U.S.C. § 77*l*(2) (1994).

[10] Section 17 prohibits material omissions and misrepresentations in the offer or sale of securities, irrespective of whether they are registered under the 1933 Act, but does not expressly provide for private remedies. *See* 15 U.S.C. § 77q (1994).

[11] 15 U.S.C. § 77*l*(2) (1994).

> of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, *by means of a prospectus or oral communication*, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.[12]

In *Gustafson v. Alloyd Co.*,[13] the Supreme Court resolved a split in the federal appellate circuits concerning the scope of liability under section 12(2)[14] when it held that the meaning of the term "prospectus" for purposes of section 12(2) was limited to a statutory prospectus contained in a registration statement soliciting the public to acquire securities.[15] In narrowing the scope of relief available under section 12(2) in *Gustafson*, Justice Kennedy, writing for a 5–4 majority, abandoned the very same traditional literal approach to statutory construction that he championed one year before in the landmark case of *Central Bank of Denver v. First Interstate Bank of Denver*,[16] which eliminated liability for aiders and abettors under section 10(b),[17] and consequently Rule 10b-5, of the Securities Exchange Act of 1934 (hereinafter the 1934 Act).[18] Justice Thomas, writing for an unusual coalition of dissenters that included Justice Scalia, Justice Ginsburg, and Justice Breyer, sharply chastised the majority for its willingness to disrupt the process of statutory interpretation[19]

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[12] *Id.* (emphasis added).

[13] 115 S. Ct. 1061 (1995).

[14] *Compare* Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578, 595 (7th Cir. 1993) (holding that section 12(2) does apply to secondary transactions, as well as public offerings) *with* Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 693 (3d Cir. 1991) (holding that section 12(2) does not apply beyond public offerings to secondary transactions).

[15] *See Gustafson*, 115 S. Ct. at 1073–74; *infra* Part IV.C.

[16] 114 S. Ct. 1439 (1994) (following a very literal plain meaning approach in finding no basis either in the language of section 10(b) or in the legislative history to support the view of imposing private liability on aiders and abettors).

[17] 15 U.S.C. § 78j(b).

[18] *See Central Bank of Denver*, 114 S. Ct. at 1455.

[19] The disruption of the process of statutory interpretation refers to the Court's

by ignoring the statutory definition of prospectus provided by Congress in the 1933 Act, in order to achieve the majority's own policy preferences regarding the scheme of private liability under the federal securities laws.[20]

This Case Comment will analyze the *Gustafson* decision and address the implications of the majority's cavalier approach to statutory interpretation with respect to the private liability scheme of the federal securities laws, as well as larger concerns of the proper interpretive role of the federal courts.[21] Part II reviews the background to *Gustafson*, focusing on the incremental restriction of the implied civil remedy for fraud in Rule 10b-5[22] by the Supreme Court in the past two decades and the subsequent rebirth of the once dormant section 12(2) express private right of action. This discussion will also emphasize the strict, literal approach applied consistently by the Supreme Court in narrowing the scope of Rule 10b-5. Part III discusses the conflict in the federal appellate circuits with respect to the scope of section 12(2). Part IV reviews the facts, procedural history, holding, and reasoning of the *Gustafson* decision. Part V analyzes *Gustafson* and discusses its implications for the private liability scheme of the federal securities laws and the proper interpretive role of the judicial branch. Part VI raises some additional implications of the decision.

II. BACKGROUND TO *GUSTAFSON*

Section 10(b) of the 1934 Act makes it "unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities Exchange]

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abandonment of its normal method of analyzing statutes. This disruption will be explained in Part IV in the discussion of *Gustafson* and analyzed again in Part V.A.

20 *See Gustafson*, 115 S. Ct. at 1078–79 (Thomas, J., dissenting).

21 This Case Comment title's reference to "red means green" has three purposes. First, "red means green" reminds the reader that the *Gustafson* Court ignored a red light, namely the cardinal rule of statutory interpretation that one should not proceed beyond the plain meaning of a statute where the language is unambiguous. In effect, the Court treated that red light as if it were green and proceeded directly to its intended policy goal of harmonizing section 12(2) with its Rule 10b-5 jurisprudence. Second, "red means green" refers to the methodology that the Court employed in order to obfuscate the plain meaning of section 12(2). In the end, the Court would have one believe that Congress's intent to say "red" (*i.e.*, section 2(10)'s statutory definition of prospectus) really meant "green" (*i.e.*, the narrower definition of prospectus as defined in section 10). Third, the title hints at the *Gustafson* Court's subtle message to the lower courts to continue their tough stance toward securities fraud plaintiffs bringing federal actions.

22 17 C.F.R. § 240.10b-5 (1996); *see infra* text accompanying notes 27–31.

Commission may prescribe."[23] In 1942, the Commission, pursuant to the power conferred upon it by section 10(b), promulgated Rule 10b-5, which prohibits, inter alia, "mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in light of circumstances under which they were made, not misleading."[24]

Although there is no express civil remedy provided for a violation of section 10(b) or Rule 10b-5, an implied private right of action was first established under Rule 10b-5 by a federal district court in 1946.[25] In 1971, after twenty-five years of tacit acquiescence in the development of a Rule 10b-5 private liability scheme in the district and circuit courts, the Supreme Court confirmed the existence of the Rule 10b-5 private action with little discussion.[26]

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[23] 15 U.S.C. § 78j(b) (1994). Section 10(b) of the 1934 Act only makes activity unlawful to the extent that the Securities Exchange Commission (hereinafter Commission) adopts a rule prohibiting the activity. *See id.* Therefore, courts have largely focused on whether the Commission has acted within the scope of its authority pursuant to section 10(b). *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[24] Rule 10b-5 reads in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1996).

[25] The Rule 10b-5 implied right of action was established in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

[26] *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). Subsequent Supreme Court decisions began to limit the scope of the private right of action under Rule 10b-5. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731–55 (1975) (holding that in order to maintain a Rule 10b-5 action, the plaintiff must be either a purchaser or seller of the securities in question); *Ernst & Ernst*, 425 U.S. 185, 194–214 (ruling that a showing that the defendant acted with scienter rather than mere negligence is required to maintain a Rule 10b-5 action); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473–474 (1977) (stating that the conduct of the defendant in a Rule 10b-5 action must be "deceptive"); *see also infra* Part II.A.

A. *The Supreme Court's Incremental Restriction of the Rule 10b-5 Action*

In 1976, the Supreme Court began to assert itself by insisting upon a literal approach to statutory construction with respect to implied private actions for violations of Rule 10b-5.[27] In the watershed case of *Ernst & Ernst v. Hochfelder*,[28] the Supreme Court held that an element of scienter was required in order to maintain an action under section 10(b) of the 1934 Act,[29] thereby refusing to read section 10(b) and its private remedy under Rule 10b-5, to impose liability for mere negligence.[30]

In *Ernst & Ernst*, the Court defined scienter, as applied to an implied private action under section 10(b) and Rule 10b-5, to refer to "a mental state embracing intent to deceive, manipulate or defraud."[31] In a footnote, the Court did leave open the possibility that this definition could be relaxed somewhat by writing that "certain areas of the law [consider] recklessness . . . to be a form of intentional conduct for purposes of imposing liability for some act."[32] Consequently, the lower federal courts seized the Court's invitation to define scienter by a less stringent standard, namely that of recklessness.[33] Nevertheless, proving recklessness rather than mere negligence still remained a formidable task for plaintiffs bringing Rule 10b-5 actions.

B. *The Rebirth of Section 12(2)'s Express Private Right of Action*

Ernst & Ernst gave the securities plaintiffs' bar a reason to seek other more desirable avenues of relief, given the difficulty in pleading and proving fraud in a Rule 10b-5 action.[34] Section 12(2)'s express private action, once largely

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27 *See infra* text accompanying notes 28–33.

28 425 U.S. 185.

29 *See id.* at 212.

30 The *Ernst & Ernst* Court properly focused on the "manipulative or deceptive device or contrivance" language contained in section 10(b) of the 1934 Act, as this language grants and limits the authority of the Commission to promulgate Rule 10b-5. *See id.* at 214.

31 *Id.* at 194 n.12.

32 *Id.* Even though the Court declined to decide whether reckless conduct would satisfy Rule 10b-5's scienter requirement, the rule at common law in an action in deceit equated scienter with a reckless disregard for the truth or the making of a statement with no belief in its truth. *See, e.g.*, Derry v. Peek, 14 App. Cas. 337 (House of Lords 1889).

33 *See* Louis Loss, Commentary, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 910 (1992).

34 Over the years, the federal courts have established a significant number of procedural and doctrinal barriers, in particular at the pleading stage of Rule 10b-5 fraud

considered to be redundant given the broad scope of the Rule 10b-5 implied private action,[35] arose from the ashes to become the new darling of disappointed investors and the securities plaintiffs' bar.[36] Notwithstanding section 12(2)'s limitation of any recovery to a rescissionary measure[37] (with only a minor exception)[38] and privity requirement,[39] the express private action under section 12(2), in contrast to Rule 10b-5, actually places the burden on the defendant to demonstrate that he "did not know, and in the exercise of reasonable care could not have known," of the untruth or omission.[40] Thus, section 12(2)'s negligence-based standard provided a purchaser with a more

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actions. For example, federal courts require Rule 10b-5 claims to comply with the heightened particularity requirements of Federal Rule of Civil Procedure 9(b), as fraud lies at the core of such claims. *See, e.g.*, Shields v. Citytrust BanCorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994); Lewis v. Chrysler Corp., 949 F.2d 644, 650 (3d Cir. 1991).

Congress has also recently codified procedural and substantive barriers of its own dealing with the allegation of fraud in securities class action lawsuits. The Private Securities Litigation Reform Act of 1995 became law on December 22, 1995 following the United States Senate's override of President Clinton's veto of the bill. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995). Championed as a central part of the House GOP's "Contract with America," among other things, it requires plaintiffs to allege concrete facts for each allegation of fraudulent behavior. *See* David R. Sands, *Senate Vote Completes Override of Clinton Veto; White House Lobbying Effort Fails; Lawsuit-Reform Bill Passes, 68–30*, WASH. TIMES, Dec. 23, 1995, at 2A. *See generally* JAMES HAMILTON, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: LAW AND EXPLANATION (CCH 1996).

[35] *See* Steven Thel, Essay, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM L. REV. 1183, 1189 (1995).

[36] *See* Loss, *supra* note 33, at 910.

[37] *See* 15 U.S.C. § 77*l*(2) (1994).

[38] This exception to a rescissionary remedy exists where the purchaser sells the security. *See* HAZEN, *supra* note 4, § 7.5, at 410–11. The purchaser is entitled to recover the out-of-pocket loss incurred in selling the security at a price below what he or she initially paid for the security. *See id.* § 7.5.3, at 438.

[39] The requirement of privity is embedded in the language of section 12(2), which states that "[a]ny person . . . who offers or sells a security . . . shall be liable to the person purchasing such security from him." 15 U.S.C. § 77*l*(2) (1994). In fact, the failure of section 12(2) to provide relief to a defrauded seller is frequently cited as a primary reason for creating Rule 10b-5 and implying a private right of action thereunder. *See, e.g.*, HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 15.01, at 15-1 to -2 (1993); ROBERT W. HAMILTON, CORPORATIONS: CASES AND MATERIALS 944–48 (4th ed. 1990); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Post-Distribution Markets*, 32 WM. & MARY L. REV. 847, 873 n.143 (1991).

[40] 15 U.S.C. § 77*l*(2) (1994).

attractive basis for bringing an action than the recklessness requirement of Rule 10b-5.[41]

III. THE CIRCUIT CONFLICT REGARDING THE SCOPE OF SECTION 12(2)

The broad language of section 12(2)'s express right of action created a much more attractive remedy for a disappointed investor than did the narrower Rule 10b-5 action.[42] As more investors brought actions under section 12(2) in response to the Supreme Court's restriction of the implied private action under Rule 10b-5, a split emerged in the federal circuits in the last five years concerning section 12(2)'s scope.[43] This debate focused on the question of whether section 12(2) provided a remedy for both public offerings and secondary purchases of securities or merely the former of the two transactions.

A. *The Third Circuit's Approach to 12(2)*

The first federal circuit to squarely address the debate over the scope of section 12(2) was the Third Circuit in *Ballay v. Legg Mason Wood Walker, Inc.*[44] In *Ballay*, the plaintiff-investors sued their brokerage firm, inter alia, under section 12(2) for alleged oral misrepresentations concerning the book value of certain securities issued by a company that had recently emerged from bankruptcy.[45] The district court, relying on the Supreme Court's decision in *United States v. Naftalin*,[46] held that the plain language of section 12(2) supported a broad reading of the scope of that provision to include both initial and secondary market transactions.[47] On appeal, the Third Circuit reversed the judgment, holding that the language and legislative history indicated that Congress did not intend section 12(2) to be made available to protect purchasers in secondary market transactions.[48]

In examining section 12(2)'s language, the Third Circuit focused on the

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41 *See* Loss, *supra* note 33, at 910; *see also* Catherine M. Epstein, Comment, *"Reasonable Care" in Section 12(2) of the Securities Act of 1933*, 48 U. CHI. L. REV. 372 (1981).

42 *See* Loss, *supra* note 33, at 912–13.

43 *See supra* note 14 and accompanying text.

44 925 F.2d 682 (3d Cir. 1991).

45 *See id.* at 684–85.

46 441 U.S. 768 (1979) (holding that a customer's illegal short sales violate the 1933 Act's antifraud provision, section 17, as a fraud on the broker conducting the transaction).

47 *See Ballay*, 925 F.2d at 686–87. For an earlier discussion of the crucial distinction between initial and secondary market transactions, see *supra* note 7.

48 *See id.* at 692; *see infra* notes 49–52 and accompanying text.

meaning of the words "oral communication" as used in section 12(2) in the phrase "prospectus or oral communication."[49] The Third Circuit relied primarily on the canon of statutory construction *noscitur a sociis* ("a word is known by the company it keeps") to define oral communication in section 12(2). Employing this canon, the Third Circuit reasoned that because the term "prospectus" is typically associated with an initial distribution of securities, the term "oral communication" must be limited as well to initial distributions.[50] Thus, under this line of reasoning, the Third Circuit interpreted the language of section 12(2) to refer only to initial trading of securities.[51]

The Third Circuit also found nothing in the legislative history[52] or structure[53] of the 1933 Act indicating a specific intent to extend section 12(2) beyond the 1933 Act's primary purpose of regulating initial distributions.[54] At least one commentator praised the Third Circuit for pushing the envelope by embracing a structural, albeit largely policy-oriented, approach to statutory interpretation.[55] Arguably, in *Gustafson*, the Supreme Court followed the Third Circuit's structural and policy-oriented approach in construing the scope of section 12(2).[56]

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[49] *See Ballay*, at 688.

[50] *See id.*

[51] *See id.*

[52] *See id.* at 690 ("Congress' intent in enacting the 1933 Act was clearly to regulate initial offerings.").

[53] *See id.* at 691. The Third Circuit noted:

> In addition, the 'structure' of the Act supports the more narrow reading of section 12(2). Section 12(2) follows section 11 and section 12(1), which govern the registration of securities and create civil liability for sales of unregistered securities, respectively, and appears before section 13, which provides the statute of limitation for both sections 11 and 12. All of these sections deal with initial distributions. Congress' placement of section 12(2) squarely among 1933 Act provisions concerned solely with initial distributions of securities indicates that it designed section 12(2) to protect buyers of initial offers against fraud and misrepresentation.

Id. (citations omitted).

[54] *Id.* at 690.

[55] *See* Maxwell O. Chibundu, *Structure and Structuralism in the Interpretation of Statutes*, 62 U. CIN. L. REV. 1439, 1496–1507 (1994) (using the *Ballay* court's methodology as a prime case study to illustrate one court's extensive use of "structure" in judicial interpretation of a statute).

[56] *See infra* Parts IV & V.

B. *The Seventh Circuit's Literal Approach to 12(2) in* Pacific Dunlop Holdings, Inc.

In *Pacific Dunlop Holdings, Inc. v. Allen & Co.*,[57] the Seventh Circuit refused to follow the Third Circuit's lead two years later when it addressed the scope of section 12(2). In *Pacific Dunlop*, the plaintiff asserted that misstatements in the representations obtained from the shareholder seller in connection with a private stock purchase agreement violated section 12(2).[58] Based on the Third Circuit's holding in *Ballay*, the district court dismissed the claim.[59] On appeal, the Seventh Circuit reversed and remanded, holding that the private stock purchase agreement was a prospectus within the meaning of that term in section 12(2) and reading the scope of section 12(2) to apply to secondary market transactions, as well as public offerings.[60]

In its reasoning, the Seventh Circuit first emphasized the broad statutory definition of prospectus provided by Congress in section 2(10) of the 1933 Act.[61] In addition, in stark contrast to the reasoning of the Third Circuit, the Seventh Circuit found no basis in the structure or legislative history of the 1933 Act to ignore the statutory definition of prospectus in section 2(10).[62] Accordingly, the Seventh Circuit interpreted the term "prospectus" as used in section 12(2) by reference to the broad definition of this term contained in section 2(10). The Seventh Circuit then concluded that initial and secondary market transactions were within the scope of section 12(2).[63]

IV. THE *GUSTAFSON* DECISION

A. *Facts*

In 1989, the shareholders of Alloyd Holdings, Inc., (Alloyd Holdings)

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57 993 F.2d 578 (7th Cir. 1993).

58 *See id.* at 579. The private stock purchase agreement would be a secondary market transaction or a private sale. Such a private resale of stock in a secondary market transaction is typically subject to an exemption from section 5's registration requirement for any public offering. *See supra* notes 6–7.

59 *See Pacific Dunlop*, 993 F.2d at 579.

60 *See id.* at 595.

61 *See id.* at 582–83. ("[W]e cannot say that the . . . text of section 12, and in particular the context of the word 'prospectus' in section 12(2), *require[s]* a definition of prospectus contrary to the broad definition of section 2(10)."). *Id.* at 588.

62 *See id.* at 588.

63 *See id.* at 595.

agreed to buy substantially all of the issued and outstanding common stock of Alloyd, Inc., (Alloyd) a manufacturer of plastic packaging and heat sealing equipment, from the three shareholders of Alloyd (led by Gustafson) in a private contract of sale.[64] According to the terms of the private contract of sale, Alloyd Holdings agreed to pay the sole shareholders of Alloyd approximately $18.7 million for the stock plus a payment ("adjustment amount") of approximately $2.1 million, which reflected the estimated increase in Alloyd's net worth from the end of the previous year, the last year for which verifiable financial data was available.[65] The private contract of sale contained numerous representations and warranties by the selling shareholders, including assurances that Alloyd's financial statements fairly presented the company's financial condition and that no adverse material change in financial condition had taken place since the date of the last financial statement audit.[66] The private contract of sale provided for an adjustment to be given to a disappointed party if the year-end audit and financial statements revealed a variance between the estimated and actual increased value.[67]

Subsequently, the year-end audit did reveal that Alloyd's actual earnings were lower than the estimates relied upon by the parties in negotiating the approximately $2.1 million adjustment amount.[68] Accordingly, the buyers, Alloyd Holdings, had the right to recover an adjustment in the amount of $815,000 plus interest under the terms of the private contract of sale.[69] Instead of seeking this amount, the purchasers brought suit to rescind the private contract of sale pursuant to section 12(2).[70]

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[64] *See* Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1064 (1995). Alloyd, Inc. was incorporated, and its stock had been issued in 1961. In 1989, Gustafson engaged KPMG Peat Marwick to find a buyer for the stock of Alloyd, Inc. KPMG reached an agreement with Alloyd Holdings, Inc., a new corporation formed to acquire the Alloyd stock. *See id.*

[65] *See id.* at 1065.

[66] *See id.*

[67] *See id.*

[68] *See id.*

[69] *See id.*

[70] *See id.* The buyers in *Gustafson* were obviously more sophisticated than the typical small investor. They negotiated a deal that specifically contemplated an adjustment amount to be given to the disappointed party. Therefore, given the fact that the parties to the private contract of sale had agreed to a contractual remedy if the financials fell short of the seller's representations, the *Gustafson* majority may have felt justified in narrowing the scope of section 12(2) to prevent the plaintiff-buyers from obtaining a right of rescission. Perhaps this supports the old adage that tough cases make bad law.

B. *Procedural History*

The disappointed purchasers of Alloyd stock brought suit in the United States District Court for the Northern District of Illinois, seeking outright rescission of the sales contract under section 12(2).[71] Alloyd alleged that statements made by Gustafson and his coshareholders regarding the financial data of their company were inaccurate, rendering untrue the representations and warranties section of the contract.[72] Alloyd further claimed that the private sales contract was a prospectus within the meaning of section 12(2), so that the misstatements in the sales contract gave rise to civil liability under section 12(2).[73]

The district court granted the motion for summary judgment by Gustafson in reliance on the Third Circuit's opinion in *Ballay*, holding that section 12(2) applied only to initial offerings of stock.[74] On review, the Seventh Circuit Court of Appeals vacated the lower court's ruling and remanded the case back to the district court due to the intervening contrary decision of the Seventh Circuit in *Pacific Dunlop*.[75] The Supreme Court granted certiorari to resolve this conflict in the federal circuits.[76]

C. *The Majority Opinion*

A glance at the composition of the majority and dissent shows that *Gustafson* was indeed a peculiar opinion. The majority was composed of Chief Justice Rehnquist, Justice Stevens, Justice O'Connor, the opinion author Justice Kennedy, and Justice Souter, while the dissent consisted of an unusual alliance of Justice Scalia, Justice Thomas, Justice Ginsburg, and Justice Breyer.[77]

Writing for a 5-4 majority, Justice Kennedy, the author of the *Central*

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[71] *See id.*

[72] *See id.*

[73] *See id.*

[74] *See id.* For an earlier discussion of the Third Circuit's reasoning in *Ballay*, see *supra* notes 44-56 and accompanying text.

[75] *See id.* For an earlier discussion of the Seventh Circuit's reasoning in *Pacific Dunlop*, see *supra* notes 57-63 and accompanying text.

[76] *See Gustafson*, 115 S. Ct. at 1065.

[77] Justice Thomas dissented, joined by all the other dissenters, while Justice Ginsburg also authored a separate dissenting opinion joined by Justice Breyer. This alliance is unusual when one considers the perceived differences in judicial philosophy between Justice Scalia and Justice Thomas, on the one hand, and Justice Ginsburg and Justice Breyer, on the other.

Bank of Denver decision,[78] began his analysis in a peculiar way. Rather than examining the statutory definition of prospectus provided by Congress in section 2(10), Justice Kennedy first turned to section 10 of the 1933 Act to interpret the meaning of the term.[79] Justice Kennedy stated that the language of section 10 provides a broad mandatory requirement that a prospectus shall contain the information contained in the registration statement.[80] Justice Kennedy argued that although section 10 does not actually define the term "prospectus," section 10 does "instruct us what a prospectus cannot be if the Act is to be interpreted as a symmetrical and coherent regulatory scheme, one in which the operative words have a consistent meaning throughout."[81] Accordingly, under Justice Kennedy's reasoning, the sales contract in question was clearly not a prospectus within the meaning of section 10, because a prospectus under section 10 is limited to documents associated with a public offering that are subject to the requirement of filing a section 5 registration statement.[82] Therefore, Justice Kennedy turned to the question of whether prospectus must be given the same interpretation in sections 10 and 12 of the 1933 Act.[83]

Based on the earlier reasoning developed by the Court to disregard section 2(10) and use section 10 as the starting point for defining the term "prospectus," the majority stated that it must use section 10 as "guidance and instruction for giving the term [prospectus] a consistent meaning throughout the [1933] Act."[84] Justice Kennedy then relied on the Third Circuit's reasoning in *Ballay* to conclude that the structure of the 1933 Act also supports his determination that the term "prospectus" must be given the same meaning throughout the statute.[85]

Justice Kennedy also examined the overall structure of the 1933 Act. First,

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[78] *See supra* note 16 and accompanying text.

[79] *See Gustafson*, 115 S. Ct. at 1066.

[80] *See id.*

[81] *Id.* at 1066–67.

[82] *See id.* at 1067.

[83] *See id.* at 1066–67.

[84] *Id.* at 1067.

[85] *See id.* ("The conclusion that prospectus has the same meaning, and refers to the same types of communications (public offers by an issuer or its controlling shareholders), in both [sections] 10 and 12 is reinforced by an examination of the *structure* of the 1933 Act.") (emphasis added); *see also supra* notes 49–56 and accompanying text. Although Justice Kennedy stated that a structural approach merely reinforced its reading of the term "prospectus" in the 1933 Act, it is noteworthy that Justice Kennedy's opinion took this next step in its analysis before even considering the statutory definition of this term set forth in section 2(10).

Justice Kennedy's structural analysis of the 1933 Act initially catalogued the Act's provisions and concluded that under the "most natural and symmetrical reading" of the entire Act, section 12(2) liability cannot be imposed in the absence of an obligation to distribute a section 10 prospectus.[86] Second, the majority claimed that section 12(2)'s own terms exempting prospectuses for government-issued securities from the reach of its coverage would make it nonsensical to grant immunity to a private seller based solely on the reason that the seller's misstatements happen to relate to government-issued securities.[87] In contrast, the Court reasoned that the exemption in section 12(2) for prospectuses for government-issued securities only becomes comprehensible when one interprets the term "prospectus" in section 12(2) consistent with section 10, thus limiting the term "prospectus" to offering documents distributed in connection with public offerings.[88] Third, the majority stated that the primary purpose of the 1933 Act was to regulate initial distributions of newly-issued stock from corporate issuers.[89] Therefore, the Court argued that it could not conclude that section 12(2) created "vast additional liabilities" that are designed to provide a remedy for obligations created under the 1933 Act.[90]

Justice Kennedy thereafter rejected Alloyd's argument, based on *Pacific Dunlop*, that the term "prospectus" under section 12 represents a "broader set of communications than the same term in [section] 10."[91] Justice Kennedy criticized the dissent's "discovery" of two different types of prospectuses: formal prospectuses that are subject to both section 10 and section 12, and informal prospectuses, subject only to section 12 but not section 10.[92] In an odd twist, Justice Kennedy then contended that since the 1933 Act never explicitly mentions formal or informal prospectuses, the burden of persuasion should be placed on those who view prospectus as meaning "one thing in [section] 12 and another in [section] 10 to adduce strong textual support for that conclusion."[93]

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[86] *See id.*

[87] *See id.* at 1067–68.

[88] *See id.* at 1068.

[89] *See id.*

[90] *See id.*

[91] *Id.* The Seventh Circuit's *Pacific Dunlop* decision states: "[T]he 1933 Act contemplates many definitions of a prospectus. Section 2(10) gives a single, broad definition; section 10(a) involves an isolated, distinct document—a prospectus within a prospectus; section 10(d) gives the Commission authority to classify many." Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578, 584 (7th Cir. 1993).

[92] *See Gustafson*, 115 S. Ct. at 1068.

[93] *Id.* at 1068–69. This statement illustrates the perverse logic of the majority. The majority has ignored the statutory definition of the term "prospectus" in section 2(10) up to

The Court also dismissed Alloyd's argument, concentrating on the word "communication" within the broad statutory definition of prospectus in section 2(10), that a material misstatement in any communication offering a security for sale gives rise to liability under section 12(2).[94] The Court maintained that Alloyd's reading of communication in the statutory definition of prospectus in section 2(10) is inconsistent with at least two canons of statutory construction.[95] First, the Court stated that a broad reading of communication to include every written communication would violate the canon that the Court will attempt to avoid an interpretation that renders some words altogether redundant.[96] The Court maintained that a broad reading of communication would render "notice, circular, advertisement, [and] letter" redundant, as they all are forms of written communication.[97] Second, the majority argued that a broad reading of section 2(10) is inconsistent with the canon of *noscitur a sociis*.[98] Accordingly, the majority concluded that under this canon of construction, the plaintiff-purchaser's suggested interpretation of section 2(10) would give it unintended breadth.[99]

Justice Kennedy offered instead a "better reading" of section 2(10).[100] He argued that inclusion of the term "communication" in section 2(10), along with a list of other documents used for public communication suggests that communication refers to documents of wide dissemination.[101] Citing the "well understood" meaning of prospectus in 1933 as a mere term of art referring to any document soliciting the public to acquire securities from the issuer, Justice Kennedy adopted a functional reading of communication as relating to writings that are akin to the other writings specified in section 2(10), such as "notice, circular, [and] advertisement."[102]

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this point in the opinion. Instead, the majority jumped to section 10, an operational provision, and used it to define the term "prospectus" under section 12(2). Now, as the coup de grace, the majority, suddenly insisting on a plain meaning textual analysis, placed the burden on the proponents of the view that the term "prospectus" means something different in section 12(2) than in section 10, an operational provision. The majority has created its own presumption that the term "prospectus," wherever it appears in the 1933 Act, refers to public offerings. However, this presumption is backwards given the broad statutory definition provided by Congress in section 2(10).

[94] *See id.* at 1069; *see also supra* note 8 and accompanying text.

[95] *See Gustafson*, 115 S. Ct. at 1069.

[96] *See id.*

[97] *See id.*

[98] *See id.*; *see also supra* text accompanying note 50.

[99] *See Gustafson*, 115 S. Ct. at 1069.

[100] *See id.*

[101] *See id.* at 1070.

[102] *See id.* Justice Kennedy actually cited the second edition of *Black's Law Dictionary*

Justice Kennedy's conclusion, that the word "prospectus" is merely a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder, is the fundamental weakness of the Court's analysis of section 12(2)'s scope in the *Gustafson* decision. This cornerstone holding in *Gustafson* reversed a long-standing belief in the proper interpretation of section 12(2) consistent with the broad definition of prospectus in section 2(10).[103] This broader interpretation of the scope of section 12(2) had led nearly all contemporary commentators to believe prior to *Gustafson* that section 12(2) was applicable to both private and secondary transactions, as well as public offerings.[104]

Surprisingly, Justice Kennedy then actually sought to buttress the holding that the term "prospectus" relates to public offerings by citing the *Naftalin* decision, the same case relied on by the Seventh Circuit in *Pacific Dunlop*.[105] The *Naftalin* Court had determined, by reference to both the statutory language and legislative history of the 1933 Act, that section 17(a) "was 'intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading.'"[106] Justice Kennedy observed that the *Naftalin* Court labeled its own holding as "'a major departure from th[e] limitation [of the 1933 Act to new offerings].'"[107] Accordingly, Justice Kennedy distinguished *Gustafson* from *Naftalin*, concluding that "[n]o comparable legislative history even hints that [section] 12(2) was intended to be a free-standing provision effecting expansion of the coverage of the entire statute. The intent of Congress and the design of

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published in 1910 to illustrate this "well understood" meaning of prospectus. *See id.*; (BLACK'S LAW DICTIONARY 959 (2d ed. 1910) (defining "prospectus" as a "document published by a company . . . or by persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares . . . and inviting the public to subscribe to the issue").

[103] Justice Ginsburg underscores this point in her dissent. *See Gustafson*, 115 S. Ct. at 1082-83 (Ginsburg, J., dissenting).

[104] *See, e.g.*, HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 14.09, at 14-34 to -48 (1994); Steven W. Hansen et al., *Developments in Broker-Customer Litigation*, 25 REV. SEC. & COMMODITIES REG. 193, 197-99 (1992); Loss, *supra* note 33; Therese Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817 (1994) [hereinafter Maynard, *The Future of Section 12(2)*]; Maynard, *supra* note 39, at 847–49; Robert A. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 ALB. L. REV. 97, 101-03 (1991); Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) As an Aftermarket Remedy for Disclosure Violations*, 47 BUS. LAW. 711, 712-14 (1992).

[105] *See Gustafson*, 115 S. Ct. at 1070–71.

[106] *Id.* at 1070 (alteration in original) (citing Naftalin, 441 U.S. at 777–78 (1979)).

[107] *Id.* (alteration in original) (citing *Naftalin*, 441 U.S. at 777–78).

the statute require that [section] 12(2) liability be limited to public offerings."[108] In Justice Kennedy's view, section 12(2) lacked the same degree of support in the legislative history as section 17(a), and thus was not capable of being a "free-standing provision" like section 17(a) under the reasoning of *Naftalin*.[109]

Finally, Justice Kennedy tersely stated the large policy concerns raised by Alloyd's proposed broader reading of section 12(2).[110] Without explicitly mentioning the policy impact that a broad reading of section 12(2) would have on the restriction of the Rule 10b-5 private liability scheme that the Supreme Court has overseen since the *Ernst & Ernst* case, Justice Kennedy's words do seem implicitly to address this issue:

> It is not plausible to infer that Congress created this extensive liability [provision in section 12(2)] for every casual communication between buyer and seller in the secondary market. It is often difficult, if not altogether impractical, for those engaged in casual communications not to omit some fact that would, if included, qualify the accuracy of a statement. *Under Alloyd's view any casual communication between buyer and seller in the aftermarket could give rise to a rescission, with no evidence of fraud on the part of the seller or reliance on the part of the buyer. In many instances buyers in practical effect would have an option to rescind, impairing the stability of past transactions where neither fraud nor detrimental reliance on misstatements or omissions occurred.* We find no basis for interpreting the statute to reach so far.[111]

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[108] *See id.* at 1071.

[109] *See id.* Justice Kennedy responded later in the opinion to Justice Ginsburg's dissenting argument, echoed also in the Commission's amicus brief, that the legislative background of the 1933 Act supports Alloyd's construction of section 12(2). *See id.* Justice Kennedy cited a House Report which stated that section 12 liability is to be limited to that which is in connection with a document soliciting the public. Moreover, in reliance on the House Report, Justice Kennedy concluded that "[n]othing in the legislative history . . . suggests Congress intended to create two types of prospectuses, a formal prospectus required to comply with both [sections] 10 and 12, and a second, less formal prospectus, to which only [section] 12 would be applicable." *Id.* at 1073.

[110] *See id.* at 1071.

[111] *Id.* at 1071 (emphasis added). Again, the particular facts of *Gustafson* do seem to make the result justifiable only inasmuch as the sophisticated plaintiffs clearly used section 12(2) as an option to rescind in this case. Nevertheless, the breadth of the Court's holding in *Gustafson* swept many other less fortunate disappointed investors under its scope. *See supra* note 70.

D. *Justice Thomas's Dissent*

Justice Thomas's basic premise was that the majority had literally turned the process of statutory interpretation on its head.[112] Justice Thomas believed that the proper approach to interpreting section 12(2) was to start with that provision itself.[113] After examining section 12(2)'s language, Justice Thomas then suggested resolving any ambiguities in that provision by turning to the 1933 Act's definitional section, section 2(10).[114] Only if that inquiry proved fruitless did Justice Thomas advocate analyzing the overall structure of the 1933 Act to clarify any uncertainties about the plain language of the statute.[115] Following such a textual analysis, Justice Thomas concluded that section 12(2) applied to public offerings,[116] as well as secondary or private sales of a security.[117]

In analyzing the language of section 12(2), Justice Thomas conceded that absent any other statutory direction, one might construe prospectus to mean a

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[112] Justice Scalia and Justice Thomas are the main proponents of conventional textualism on the current Supreme Court. As a conventional textualist, Justice Thomas's view "[focuses on] the 'text' or 'plain wording' of the statute . . . as the starting point for any construction of law." Chibundu, *supra* note 55, at 1454.

Justice Thomas essentially argues here that the majority, by ignoring the broad statutory definition of prospectus provided by Congress in section 2(10), has circumvented the plain wording of the 1933 Act. Instead, according to Justice Thomas, the majority has first turned to an operational section of the 1933 Act, section 10, in order to interpret prospectus in section 12(2) and throughout the statute. *See Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting) ("Unfortunately, the majority has decided to interpret the word 'prospectus' in [section] 12(2) by turning to sources outside the four corners of the statute, rather than by adopting the definition provided by Congress.").

[113] *See Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting).

[114] *See id.* (Thomas, J., dissenting).

[115] *See id.* at 1075-76 (Thomas, J., dissenting).

[116] Justice Thomas's dissenting opinion incorrectly noted at times that section 12(2), under the majority's reading, would be limited to an initial public offering. The distinction between the initial public offering and any registered public offering is a crucial one which raises the question of how knowledgeable the Court is of fundamental distinctions in federal securities law. An initial public offering represents the first time that a company relies upon public financing through the registration and sale of its securities (also known as "going public"). However, a company may embark on a registered offering again at a later time that must also satisfy the registration requirements of section 5. *See* HAZEN, *supra* note 4, § 1.6, at 67-72.

[117] *See Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting) ("Here, [section] 12(2) contains no distinction between initial and secondary transactions, or public and private sales.").

term of art which describes the transmittal of information in a public offering of a security for sale.[118] Nevertheless, because Congress did provide a very broad statutory definition of the term "prospectus" in section 2(10), Justice Thomas argued that there is no need to look beyond the language of that definition section to define prospectus in the 1933 Act.[119] Justice Thomas noted that the broad definition of prospectus in section 2(10) clearly indicated an intent by Congress to depart from the ordinary meaning of the term, by including a prospectus as only one of many documents that qualify under the section 2(10) definition of prospectus.[120] Therefore, Justice Thomas argued that "[the Court] should use [section] 2(10) to define 'prospectus' for the 1933 Act, rather than, as the majority does, use the 1933 Act to define 'prospectus' for [section] 2(10)."[121]

Justice Thomas sharply criticized the majority for seeking to create ambiguities in the broad language of section 2(10) under the guise of the maxim *noscitur a sociis*.[122] He contended that, by narrowly construing the words following prospectus in section 2(10) to refer only to forms of public dissemination that a prospectus may assume, the majority had deprived the definition section of its "[operation] as a safety net that Congress used to sweep up anything it had forgotten to include in its definition."[123] Given the broad catch-all nature of the definition of prospectus in section 2(10), Justice Thomas concluded that, as applied to section 12(2), Congress intended that secondary or private sales of a security would fall within the scope of the section.[124]

Justice Thomas, after analyzing section 12(2) in a manner consistent with the typical statutory interpretation process, then strongly chastised the majority for "transform[ing] [section] 10 into the tail that wags the 1933 Act dog."[125]

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[118] *See id.* at 1074 (Thomas, J., dissenting).

[119] *See id.* (Thomas, J., dissenting) (citing Federal Deposit Ins. Corp. v. Meyer, 510 U.S. 471, 476 (1994)).

[120] *See Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting).

[121] *Id.* at 1074–75 (Thomas, J., dissenting).

[122] *See id.* at 1075 (Thomas, J., dissenting).

[123] *Id.* (Thomas, J., dissenting) (Justice Thomas continued by stating that "[t]his is a technique Congress employed in several other provisions of the 1933 and 1934 Acts.").

[124] *See id.* (Thomas, J., dissenting).

[125] *See id.* at 1076 (Thomas, J., dissenting). Justice Thomas illustrated his point with an excellent analogy:

> Suppose that the Act regulates cars, and that [section] 2(10) of the Act defines a "car" as any car, motorcycle, truck, or trailer. Section 10 of this hypothetical statute then declares that a car shall have seatbelts, and [section] 5 states that it is unlawful to sell cars without seatbelts. Section 12(2) of this Act then creates a cause of action for

Justice Thomas presented several textual indications in the 1933 Act that Congress did not intend for prospectus to have a consistent meaning throughout the statute.[126]

Analyzing the surrounding text of section 12(2), Justice Thomas argued that there was no indication in the language of the provision that Congress intended to limit the scope of section 12(2) to initial public offerings.[127] Justice

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> misrepresentations that occur during the sale of a car. It is reasonable to conclude that [sections] 5 and 10 apply only to what we ordinarily refer to as "cars," because it would be absurd to require motorcycles and trailers to have seatbelts. But the majority's reasoning would lead to the further conclusion that [section] 12(2) does not cover sales of motorcycles, when it is clear that the Act includes such sales.

Id. (Thomas, J., dissenting).

[126] *See id.* (Thomas, J., dissenting). According to Justice Thomas, these textual indications that Congress intended prospectus to have different meanings throughout the 1933 Act included:

> First, [section] 2(10) defines "prospectus" to include not only a document that "offers any security for sale" (which is consistent with the majority's reading), but also one that "confirms the sale of any security." But the majority does not claim that [section] 10 uses the term "prospectus" to include confirmation slips. It would be radical to say that every confirmation slip must contain all the information that [section] 10 requires; only the documents accompanying an initial public offering must contain that information . . . .
>
> Second, this understanding is reinforced by [section] 2's preface that its definitions apply "unless the context otherwise requires," 15 U.S.C. § 77b. This phrase indicates that Congress intended simply to provide a "default" meaning for "prospectus." Further, nothing in [section] 12(2) indicates that the "context otherwise requires" the use of a definition of "prospectus" other than the one provided by [section] 2(10). If anything, it is [section] 10's "context" that seems to require the use of a definition which is different from that of [section] 2(10).
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> Third, the dual use of "prospectus" in [section] 2(10), which both defines "prospectus" broadly and uses it as a term of art, makes clear that the statute is using the word in at least two different senses, and paves the way for such variations in the ensuing provisions. To adopt the majority's argument would force us to eliminate [section] 2(10) in favor of some narrower, common law definition of "prospectus." Our mandate to interpret statutes does not allow us to recast Congress' handiwork so completely.

Id. (Thomas, J., dissenting).

[127] *See id.* (Thomas, J., dissenting) ("On its face, [section] 12(2) makes none of the usual distinctions between initial public offerings and after-market trading, or between public trading and privately negotiated sales. The provision does not mention initial public offerings, as do other provisions of the [1933] Act.").

Thomas pointed to section 12(2)'s lone express exception for government securities as indicative of the fact that "Congress knew how to exempt certain securities and transactions when it wanted to."[128] Responding to the majority's critique of his own reading of section 12(2) as offering no explanation for exempting government securities unless section 12(2) is limited to public offerings, Justice Thomas offered two plausible explanations for the exception.[129] First, Congress may have decided that the imposition of liability on private or secondary sellers of government securities is unnecessary, given the wide availability of information concerning such securities from the markets or government entities.[130] Second, Congress may have decided to relax the liability burden on government securities arising from primary and secondary sales.[131]

Justice Thomas attacked the majority's structural argument that the 1933 Act's primary purpose of regulating the distribution of initial public offerings mandated a reading of its provisions limiting it to those types of sales rather than extending it to secondary sales.[132] Citing *Naftalin*, Justice Thomas noted that the Supreme Court had previously held that at least one provision of the 1933 Act, section 17, extended to after-market trading.[133] Justice Thomas observed that two arguments relevant to the present case were not accepted in *Naftalin* concerning the scope of the 1933 Act.[134] First, Justice Thomas stated that the *Naftalin* Court was not persuaded by an argument that the structure of the 1933 Act restricted the scope of section 17 to initial public offerings.[135] Second, he noted that the *Naftalin* Court had rejected the contention that the 1933 Act's provisions applied solely to initial offerings, while the 1934 Act's Rule 10b-5 antifraud provision reached secondary sales.[136] Moreover, Justice Thomas pointed to Supreme Court precedent supporting the proposition that the 1933 and 1934 Acts often overlap and prohibit similar conduct.[137] Applying *Naftalin* to the facts of *Gustafson*, in contrast to the majority's conclusion, Justice Thomas found no basis in precedent for narrowly

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128 *Id.* at 1077 (Thomas, J., dissenting).

129 *See id.* (Thomas, J., dissenting).

130 *See id.* (Thomas, J., dissenting).

131 *See id.* (Thomas, J., dissenting).

132 *See id.* (Thomas, J., dissenting).

133 *See id.* (Thomas, J., dissenting) (citing United States v. Naftalin, 441 U.S. 768, 799 (1979)).

134 *See id.* (Thomas, J., dissenting).

135 *See id.* (Thomas, J., dissenting).

136 *See id.* at 1078 (Thomas, J., dissenting).

137 *See id.* (Thomas, J., dissenting) (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 383 (1983)).

interpreting section 12(2), in order to limit the provisions of the 1933 Act to initial public offerings.[138]

Reserving his most scathing criticism for last, Justice Thomas sharply chastised the majority for its policy-motivated analysis of section 12(2).[139] Given the upside-down approach to statutory interpretation employed by the majority, Justice Thomas inferred that the majority's reading of section 12(2) reflected a policy fear that a broad reading of section 12(2) to reach secondary and private purchases of securities would likely increase the level of securities litigation.[140] Admitting his own belief that a broad reading of section 12(2) would likely spur litigation, Justice Thomas nevertheless asserted that Congress must determine the appropriate level of liability for participants in the securities markets.[141] Citing *Central Bank of Denver*, Justice Thomas chided the *Gustafson* majority (and perhaps, in particular, the author of that opinion, Justice Kennedy) for jettisoning the basic rationale of that case, that policy concerns should not "'override [the Court's] interpretation of the text and structure of the [1934] Act.'"[142] With a degree of remorse, Justice Thomas noted that "[u]nfortunately, the majority's decision to pursue its policy preferences comes at the price of disrupting the process of statutory interpretation."[143]

E. *Justice Ginsburg's Dissent*

Justice Ginsburg, joined by Justice Breyer, expressed her agreement with Justice Thomas's persuasive textual critique of the majority, while additionally arguing that the drafting history and long-standing academic and judicial understanding of section 12(2), going back to 1933, also weigh in favor of a

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[138] *See id.* at 1078 (Thomas, J., dissenting).

[139] *See id.* at 1078-79 (Thomas, J., dissenting).

[140] *See id.* at 1078 (Thomas, J., dissenting).

[141] *See id.* (Thomas, J., dissenting).

[142] *See id.* at 1079 (Thomas, J., dissenting). In another subtle reference to *Central Bank of Denver*, Justice Thomas suggests that the majority would have been much more literal and traditional in its approach to statutory interpretation if the case had involved a statute intended to restrict causes of action in securities cases. As a final matter, Justice Thomas concluded that the majority has also frustrated the will of Congress by supplanting the statutory definition of prospectus explicitly provided by Congress in section 2(10) with one defined by the meaning of the term used by the securities industry. *See id.* (Thomas, J., dissenting).

[143] *Id.* (Thomas, J., dissenting). Justice Thomas continued by stating that "[t]he majority's method turns on its head the common-sense approach to interpreting legal documents." *Id.* (Thomas, J., dissenting).

broad reading of section 12(2) to reach private and secondary sales of securities.[144] Against this legislative, judicial, and scholarly backdrop, Justice Ginsburg argued, Congress should be left to decide whether the policy concerns of the majority are valid and whether to amend section 12(2).[145]

Justice Ginsburg argued that the term "prospectus" has two discrete meanings in sections 10 and 12(2), bolstered textually by the broad instruction in section 2 that definitions apply "unless the context otherwise requires."[146] Justice Ginsburg also noted that the Investment Company Act of 1940 itself recognized that the 1933 Act uses the word "prospectus" in "two different senses—one in [section] 10, and another in the rest of the [1933] Act."[147]

In analyzing the legislative history of the 1933 Act, Justice Ginsburg pointed to the fact that the drafters patterned the 1933 Act after the British Companies Act, but conspicuously omitted the importation from the British statute of language that limited the scope of a prospectus to public offerings.[148] Justice Ginsburg also noted that the House Conference Report, which postdated the House Report cited by the majority, did not suggest that section 12(2) is limited to public offerings.[149] Moreover, Justice Ginsburg observed that commentators, including Felix Frankfurter, the organizer of the drafting team of the statute, firmly believed that the scope of section 12(2) reached secondary and private sales, as well as public offerings of securities.[150]

Finally, Justice Ginsburg noted that subsequent commentators have also been largely unanimous in the belief that section 12(2) extends beyond public offerings to private and secondary sales of securities.[151] Although recognizing the existence of a split in the federal appellate circuits with respect to the applicability of section 12(2) to secondary transactions, Justice Ginsburg noted that "every Court of Appeals to consider the issue [of the applicability of section 12(2) to private transactions] has ruled that private placements [of

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[144] *See id.* at 1079–80 (Ginsburg, J., dissenting).

[145] *See id.* at 1080 (Ginsburg, J., dissenting).

[146] *See id.* at 1080 (Ginsburg, J., dissenting) (citing 15 U.S.C. § 77b).

[147] *Id.* at 1080 (Ginsburg, J., dissenting).

[148] *See id.* at 1081 (Ginsburg, J., dissenting) (citing James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34 (1959) and SEC v. Ralston Purina Co., 346 U.S. 119, 123 (1953) (supporting view that Companies Act was a "statutory antecedent" of [United States] federal securities laws)).

[149] *See id.* (Ginsburg, J., dissenting).

[150] *See id.* at 1082 (Ginsburg, J., dissenting). For an explanation of the crucial operational differences between private, public, and secondary transactions, see *supra* notes 6–7.

[151] *See id.* at 1082 (Ginsburg, J., dissenting).

securities] are subject to [section] 12(2)."[152] Citing the landmark *Blue Chip Stamps* case,[153] Justice Ginsburg argued that, at least with respect to private placement transactions, the Court should accept this long-standing interpretation by the lower courts coupled with Congress's acquiescence in that interpretation.[154]

V. ANALYSIS OF *GUSTAFSON*

Although the Supreme Court's decision can be analyzed from a number of different perspectives, this Part focuses only on two crucial aspects of the decision: (1) the framework of statutory interpretation employed by the Court in its analysis of section 12(2); and (2) the validity of the policy concerns raised by the majority in *Gustafson* and whether judicial intervention was warranted under the circumstances.

A. *The Dynamics of Statutory Interpretation in* Gustafson

The major problem with *Gustafson* is the manner in which the majority ignored the plain meaning of section 12(2) of the 1933 Act. Sidestepping the statutory definition provided by Congress in section 2(10) in construing section 12(2), the Court instead applied an approach that defies a precise methodological label. Arguably, the majority has adopted a structural approach, "dynamic" approach, or some unconventional variation of a conventional textual approach.[155] Irrespective of the label one attaches to the majority's approach, *Gustafson* represented a drastic departure from the Court's consistently literal plain meaning approach in construing the federal securities laws, especially when the case is juxtaposed opposite the recent *Central Bank of Denver* decision. Consequently, *Gustafson* raises significant

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[152] *Id.* (Ginsburg, J., dissenting) (citing Metromedia Co. v. Fugazy, 983 F.2d 350, 360–61 (2d Cir. 1992); Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578, 587 (7th Cir. 1993); Haralson v. E.F. Hutton Group, Inc., 919 F.2d 1014, 1032 (5th Cir. 1990); Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093, 1099 (5th Cir. 1973).

[153] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that in order to maintain a Rule 10b-5 action, the plaintiff must be either a purchaser or seller of the securities in question).

[154] *See Gustafson*, 115 S. Ct. at 1082 (Ginsburg, J., dissenting) (citing *Blue Chip Stamps*, 421 U.S. at 733).

[155] For a criticism of dynamic interpretation, see Martin H. Redish & Theodore T. Chung, *Democratic Theory and the Legislative Process: Mourning the Death of Originalism in Statutory Interpretation*, 68 TUL. L. REV. 803, 831–37 (1994) (criticizing dynamic interpretation as a usurpation of legislative authority).

concerns as to the consistency and restraint of the Court.

The majority opinion leaves one guessing as to the approach the Court chose in interpreting section 12(2). Conspicuously, the Court refused to examine initially the provision in question, section 12(2).[156] Instead the majority leaped into its analysis by considering an operational provision, section 10, which uses the term only to indicate what a prospectus must contain in order to satisfy section 5, the registration and prospectus delivery requirement of the 1933 Act.[157] Thereafter, the Court used the definition of a prospectus derived from section 10 to give meaning to section 12(2) before even considering the statutory definition of prospectus provided in section 2(10).[158] By giving meaning to the definition section, section 2(10), by first looking to an operational provision, section 10, the *Gustafson* Court turned the process of statutory interpretation on its head.[159]

Under a literal, plain meaning approach, the Court should have first examined the language of section 12(2) to decide the proper scope of that provision.[160] Assuming that the plain meaning of section 12(2) contained some ambiguous language, the majority should have then turned to the statutory definition of prospectus contained in section 2(10) of the 1933 Act. Indeed, at this point in the analysis, the Court should have halted its analysis given the fact that Congress provided a broad definition of prospectus in section 2(10), clearly intended to sweep all forms of communication under section 2(10). As Justice Thomas pointed out in his dissent, Congress expressed a clear intent in section 2(10) to depart from the ordinary meaning of the term prospectus.[161] Therefore, the majority, by ignoring the intent of Congress to define the term "prospectus" more broadly in section 2(10) than the ordinary meaning, usurped Congress's law-making power.[162]

The Court appears to have engaged in some form of structural analysis in

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[156] *See Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting).

[157] *See Gustafson*, 115 S. Ct. at 1066.

[158] *See id.* at 1074 (Thomas, J., dissenting).

[159] *See id.* at 1076 (Thomas, J., dissenting) ("The majority transforms [section] 10 into the tail that wags the 1933 Act dog.").

[160] Justice Thomas noted that *Central Bank of Denver* affirms this notion that "'[t]he starting point in every case involving a construction of a statute is the language itself.'" *Id.* at 1074 (Thomas, J., dissenting) (alteration in original) (citation omitted) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)).

[161] *See Gustafson*, 115 S. Ct. at 1075 (Thomas, J., dissenting).

[162] *See* Jane S. Schachter, *Metademocracy: The Changing Structure of Legitimacy in Statutory Interpretation*, 108 HARV. L. REV. 593, 594 ("Our legal culture's understanding of the link between statutory interpretation and democratic theory verges on the canonical and is embodied in the principle of 'legislative supremacy.'") (footnote omitted).

interpreting section 12(2) within the larger framework of the 1933 Act and the federal securities laws. Structural analysis has been recognized as a legitimate means of ascertaining legislative intent, but usually is employed to resolve ambiguity in the language of specific provisions rather than providing a justification for ignoring them.[163] Therefore, if the majority has engaged in a form of structural analysis, it has likely been invoked in order to obfuscate the Court's ulterior goals of achieving its particular policy preferences and bringing federal securities laws within a coherent scheme of private liability.

Even if the Court intended to adopt a structural approach to the interpretation of section 12(2) in order to give a consistent meaning to the term "prospectus," serious concerns of judicial consistency are nevertheless then raised given the Court's frequent prior unwillingness to abandon a literal approach to statutory construction in federal securities cases. Most notably, in *Central Bank of Denver*, the Court ignored clear stare decisis on the Rule 10b-5 aiding and abetting issue, while relying on a very literal reading of the statute.[164]

In sum, the peculiar and unprecedented approach to statutory construction of the majority, which ignored the statutory definition of prospectus provided by Congress, has set a dangerous precedent of either turning the process of statutory interpretation on its head or adopting a structural approach to interpretation. Given the near certainty that the Court will reshelve this structural approach and return to a plain meaning approach in determining legislative intent, *Gustafson* remains a troublesome decision to reconcile with prior Supreme Court decisions like *Central Bank of Denver* that have insisted on a literal approach in restricting the scope of Rule 10b-5 and similar private liability rights of action under the federal securities laws.[165] The majority's

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[163] *See* Chibundu, *supra* note 55, at 1463–64 ("Structural analysis assumes that meaning can be derived from an examination of relationships. In conventional analysis, structure refers to the process of relying on the placement or juxtaposition of items of a statute one to another, or of a statute to other statutes.").

[164] *See supra* text accompanying notes 16–18. Every circuit court that had faced the issue had recognized aiding and abetting liability under Rule 10b-5. *See, e.g.*, Cleary v. Perfecture, 700 F.2d 774 (1st Cir. 1983); Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983); IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975); Hochfelder v. Midwest Stock Exchange, 503 F.2d 364 (7th Cir. 1974); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974); Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971). *See generally* David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting; Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

[165] The Court has rarely employed a structural approach in the past and has typically insisted on a literal approach to statutory construction. In particular, a strict literal approach

jurisprudence creates not only practical problems for those practitioners and judges that must construe the federal securities laws on a daily basis, but also raises confidence concerns about the consistency of the Supreme Court and the willingness of the Court to usurp Congress's legislative power to achieve a policy end.

B. *The Policy Argument in* Gustafson—*Is Judicial Intervention Warranted to Harmonize the Private Liability Regime Under the Federal Securities Laws?*

The willingness of the majority to commit interpretive heresy by disregarding the traditional approach to interpreting a statute consistent with its plain meaning supports an inference that the Court had an ulterior policy motive for ignoring the statute. Given the Court's gradual restriction of the Rule 10b-5 implied action from a negligence-based standard to a stricter recklessness-based standard, a broad reading of section 12(2) to reach private and secondary sales would have left a fundamental imbalance in the federal private liability scheme. Professor Steven Thel predicted quite accurately before *Gustafson* that "[i]t seems inconceivable that when the Court decides *Gustafson* it will ignore the possible implications of its decisions for the restrictive rules it has developed in its Rule 10b-5 cases."[166] Undoubtedly, the

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has characterized the Court's approach in recent years to the gradual restriction of the Rule 10b-5 action. *See supra* notes 27–33 and accompanying text.

[166] Thel, *supra* note 35, at 1191. Acknowledging the larger constitutional and policy issues raised by the Court's predicament, Professor Thel noted:

> The objection to the Court's construing section 12(2) narrowly to preserve [R]ule 10b-5 precedent is that to do so would usurp Congress' law-making power. The regime of private liability for violations of [R]ule 10b-5 is judge-made law, and conventional notions of federal judicial power suggest that such law cannot serve as a basis for ignoring the statute. This is a powerful objection, and perhaps the Court should just apply section 12(2) literally, regardless of [R]ule 10b-5. Nonetheless, the Court is likely to consider the 10b-5 issue, although it may not acknowledge doing so. Despite the problem of apparent overreaching, if the Court believes that denying some classes of buyers the remedy of section 12(2) will improve the law, then the Court should consider doing so *even though section 12(2) indicates that it is available to all buyers.*
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> ....
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> Congress may have decided in 1933 that recovery should be allowed to all buyers under section 12(2) without proof of scienter or reliance—*I think it did.* However, Congress has not decided to change the substantial body of private-liability law that the courts have developed since then. Section 10(b) of the Exchange Act, the putative legislative base for [R]ule 10b-5 liability, was not the law when section 12(2) was

majority did take into account the policy impact of a broad reading of section 12(2) on Rule 10b-5 precedent. Certainly, the majority's narrow reading of section 12(2) in *Gustafson* has closed out the possibility of "extensive liability for every casual communication between buyer and seller in the secondary market."[167] In limiting the scope of section 12(2) to purchases of securities in public offerings, the majority has indeed harmonized Rule 10b-5 and section 12(2) with respect to secondary and nonpublic offerings (*i.e.*, private transactions or "placements").[168]

The majority is misguided, however, in its attempt to harmonize the judge-made Rule 10b-5 implied private right of action with the express right of action under section 12(2). In the latter, Congress explicitly provided for a right of action that should not merely be cast aside in order to achieve the majority's end of a coherent private liability scheme. Indeed, as Professor Thel noted, "[T]he regime of private liability for violations of Rule 10b-5 is judge-made law, and conventional notions of federal judicial power suggest that such law cannot serve as the basis for ignoring the [1933 Act]."[169] Irrespective of whether the Court has merely engaged in judicial "updating"[170] of the 1933 Act or simply interpreted prior legislative silence as a license to refine the private liability regime in federal securities law,[171] it is the proper role of Congress, and not that of the Supreme Court, to determine the appropriate level of liability for participants in the securities markets.[172]

> enacted. Even when section 10(b) was enacted in 1934, no one expected it to serve as a basis for private liability, let alone for a scheme of liability that would supplant most of what the statutes did.

Id. at 1192 (emphasis added) (footnotes omitted).

[167] *Gustafson*, 115 S. Ct. at 1071.

[168] *See infra* discussion Part VI.A. For an explanation of the crucial distinctions between public, secondary, and private offerings, see *supra* notes 6–7.

[169] Thel, *supra* note 35, at 1192.

[170] Judicial updating entails a re-evaluation or reinterpretation of a statute in light of changed circumstances. For a criticism of this approach in the face of express language, see William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479, 1496–97 (1987); *see also* T. Alexander Aleinikoff, *Updating Statutory Interpretation*, 87 MICH. L. REV. 20 (1988) (stating that statutes should be read as if they were enacted yesterday); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 422–24, 493–97 (1989).

[171] Some commentators have argued that this interpretation of legislative silence is not the Court's responsibility. *See, e.g.*, Lawrence C. Marshall, *"Let Congress Do It": The Case for an Absolute Rule of Statutory Stare Decisis*, 88 MICH. L. REV. 177, 186 (1989) (condemning the notion that legislative silence in response to judicial decisions constitutes acquiescence).

[172] Professor Thel, on the other hand, attempted to argue that the Supreme Court

Undoubtedly, the majority feared that a broad reading of section 12(2) to reach secondary and private transactions would likely increase securities litigation and tie up federal dockets. Nevertheless, such policy concerns should not override an interpretation of the language and structure of the 1933 Act, where Congress provided express language to the contrary. By discarding a common-sense textual approach to interpreting a statute, the Court not only frustrated the intent of Congress when it enacted section 12(2), but also rendered those fundamental principles of statutory interpretation less certain and secure.

In summary, although there may have been some strong policy reasons for narrowing the scope of section 12(2) in order to harmonize the private liability regime under the federal securities laws, the means (*i.e.*, the disruption of the traditional textual process of statutory interpretation) necessary to achieve that end have displaced Congress's proper legislative role in this area. Given the recent override of President Clinton's veto of the Private Securities Litigation Reform Act of 1995, Congress seems as poised as ever to assert itself and make necessary corrections in the area of federal securities laws.[173] Accordingly, the Court should leave future determinations of this nature to Congress. The Supreme Court's decision has not only shown an anti-democratic lack of faith in Congress's ability to amend the language of the 1933 Act, but has served to undermine its own proper interpretive role.

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should assume a law-making role in *Gustafson* based on "the need for coherent and stable [federal securities] law, especially in light of changing circumstances, and the notion of delegated law-making power." Thel, *supra* note 35, at 1193. With respect to the first argument predicated on the need for coherent and stable law, Thel argued that the Supreme Court had largely assumed responsibility in the past for "making the rules for the whole universe of private securities litigation." *Id.* at 1195. Accordingly, Thel believed that because the Supreme Court had itself created the imbalance in the federal securities laws through its acquiescence in the implied Rule 10b-5 action, the Court had a duty to eliminate this discontinuity. This argument, of course, concedes the central point of this Case Comment, namely, that the Court ignored, in Thel's own words, "admirably clear language" in narrowing the scope of section 12(2). *See id.* at 1196–97.

[173] An argument could be made that the Private Securities Litigation Reform Act of 1995 has ratified in effect the Court's prior restriction of Rule 10b-5, as well as a narrow reading of section 12(2). *See supra* note 34. Nevertheless, the Court's transgression in usurping Congress's law-making role by ignoring the plain meaning of section 12(2) is not cleansed by subsequent ratification. If anything, Congress may have granted the Court a pardon for its transgression.

VI. Implications

A. *Alternate Routes to Recovery*

Gustafson alters the standards for liability in private placements and secondary transactions. A disappointed purchaser of securities in private or secondary transactions can no longer seek relief after *Gustafson* under the negligence-based standard of section 12(2) of the 1933 Act. Instead, a plaintiff must pursue his claims under the more stringent recklessness standard of Rule 10b-5 under the 1934 Act, which extends to both private and secondary transactions.[174]

Gustafson, however, does not affect the right of a disappointed purchaser of securities in a private or secondary transaction from bringing a negligence-based action under state securities law or common law.[175] In fact, shrewd plaintiffs' bar securities lawyers realize that state law often still provides the best opportunity for a recovery under a less stringent standard.[176] State securities law actions are not as likely to give rise to the large nationwide class actions that have characterized securities litigation under section 12(2).[177]

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[174] Section 10(b), fleshed out in Rule 10b-5, is known as the general antifraud provision and applies to both of these types of transactions. *See supra* text accompanying notes 23-24.

[175] Each state regulates securities transactions through its own statutes (also known as "blue sky" laws). Therefore, corporations must comply with the registration requirements of each state in which they intend to market their shares. The Uniform Securities Act, produced by the Commissioners on Uniform State Laws serves as a model for many states' securities laws, but because many states have amended the act significantly, there is a lack of uniformity among the states. *See* UNIF. SECURITIES ACT, 7B U.L.A. 509-687 (1985 & Supp. 1996). *See generally* Marc Steinberg, *The Emergence of State Securities Laws: Partly-Sunny Skies for Investors*, 62 U. CIN. L. REV. 395 (1993).

State legislatures have also adopted antifraud and negligence-based actions similar to those in the federal securities laws. *See, e.g.*, Kittilson v. Ford, 608 P.2d 264 (1980) (rejecting the *Ernst & Ernst* scienter standard as inapplicable to the Washington Securities Act and holding that mere negligence is sufficient to impose liability). In states where the legislature has not enacted such laws, the common law of fraud would prohibit such fraudulent practices. *See supra* note 32.

[176] *See generally* Steinberg, *supra* note 175.

[177] There may be a number of other advantages to bringing a state action depending on the jurisdiction. *See, e.g.*, OHIO REV. CODE ANN. § 2315.21(B) (Baldwin 1995) (allowing punitive damages where malice or egregious fraud is shown); Riedel v. Acutote of Colorado, 773 F. Supp. 1055 (S.D. Ohio 1991), *aff'd*, 947 F.2d 945 (6th Cir. 1991) (recognizing that section 1707.43 of the Ohio statute is a much broader provision than the parallel federal provision); *see also* Steinberg, *supra* note 175.

However, in light of the recently enacted Private Securities Litigation Reform Act of 1995, large nationwide class actions are now universally subject to a number of procedural barriers that may force disappointed purchasers as a matter of litigation strategy to seek a state or common law remedy.[178]

B. *Red Means Green?: Conflicting Messages to the Lower Courts*

Gustafson may be interpreted by the lower courts in a number of ways. First, assuming that one disregards its indefensible approach to statutory interpretation and focuses on the Court's desired policy result, the decision may be viewed as a signal to the lower courts that they are free to continue restricting access in cases of securities fraud. Before *Gustafson*, many lower courts had already adopted numerous procedural barriers aimed at curbing the flow of securities fraud cases into the federal courts.[179] The Private Securities Litigation Reform Act codifies many of these procedures with respect to class actions.[180]

A second interpretation, at least prior to the recent enactment of the federal securities litigation reform legislation, may be that the Court views itself as having a responsibility to harmonize the imbalance between the section 12(2) express private action and the Rule 10b-5 implied private action.[181] This perceived duty might be linked to the Court's prior acquiescence in the development of a judicially created implied right of action under Rule 10b-5. In essence, the Court may have perhaps felt a sense of collective responsibility for its prior acquiescence in the creation of an implied private right of action. As the Court has gradually restricted the implied Rule 10b-5 action, acting out of this collective guilt, the Court may believe itself justified in now harmonizing the standards of liability under section 12(2) and Rule 10b-5 of the federal securities laws. This interpretation would seem to explain the otherwise irreconcilable decisions authored by Justice Kennedy in *Gustafson* and *Central Bank of Denver*.[182] Prior to the recent reform legislation, the Court had largely shaped and refined the Rule 10b-5 action with tacit approval from Congress.[183] Therefore, given the recent initiative of Congress in this area, the Court may

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[178] *See supra* note 34.

[179] *See supra* note 34.

[180] *See supra* note 34.

[181] Professor Thel offered this argument before *Gustafson* as a possible justification for the Court's usurpation of Congress's law-making power. *See supra* note 172.

[182] *See supra* text accompanying notes 16–18.

[183] *See supra* note 172.

finally relieve itself of this burden and return once again to its proper interpretive role.

A third and final interpretation may be that the Court is uneasy with the rigid application of a strictly textual approach to statutory construction where the practical policy result is perceived as negative. Leaving aside serious concerns of separation of powers, the Court may feel obligated to seek a sensible policy result and "update" a statute in light of changed circumstances when Congress has acquiesced in the Court's interpretation of the statute and the statute itself is quite old.[184] Nevertheless, while judicial updating may perhaps be defensible where the language is ambiguous, such judicial amendment serves as dangerous precedent when the result is the direct contravention of the unambiguous language of a statute.

In sum, the lower courts are left with any one of a number of possible interpretations of the methodology and holding in *Gustafson*. Prior to the recent reform legislation, "the federal law of private liability for misrepresentations in securities transactions ha[d] become an ocean of common law, with only a few inconsequential statutory islands."[185] In light of the new statutory island provided by Congress, which largely codified many of the procedures and doctrines of the lower courts, courts may either perceive their role as one of continued activism in this area or limited by the new assertiveness of Congress.[186]

C. *Impact on Private and Secondary Market Transactions: Is Due Diligence Dead?*

Gustafson addresses many concerns of issuers about unanticipated liability in secondary and private securities transactions. By forcing disappointed purchasers in these types of transactions to turn to Rule 10b-5, sellers are shielded from liability unless they have acted recklessly and the purchaser has relied on the material misstatement or omission.[187] These stricter liability standards in secondary and private securities transactions may lead some sellers to consider reducing the extent of their due diligence procedures in preparation of disclosure documents used in these transactions.[188] Nevertheless, most

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[184] *See generally* Eskridge, *supra* note 170; Sunstein, *supra* note 170.

[185] Thel, *supra* note 35, at 1184.

[186] *See supra* note 34.

[187] This shield in no way, however, eliminates the ability of a disappointed purchaser to seek a state or common law remedy. *See supra* notes 175–77.

[188] *See* Michael K. Wolensky & Nannette L. Wesley, *Due Diligence in Private Placements*, *in* CONDUCTING DUE DILIGENCE 1995, at 1 (PLI Corp. Law & Practice Course

purchasers in private and secondary transactions will likely continue to insist on detailed disclosure documents being offered in the transaction process prior to such securities purchases.[189] Moreover, issuers and investment banks will likely continue to engage in detailed due diligence given the reputational and commercial benefits of such disclosure and the continued existence of state negligence-based remedies.[190]

VII. CONCLUSION

Perhaps the most troublesome legacy of *Gustafson* is the majority's misguided attempt to harmonize the judicially created Rule 10b-5 implied private right of action with section 12(2)'s legislatively authorized express right of action in order, presumably, to achieve the majority's end of a coherent private liability scheme. *Gustafson* remains a troublesome decision to reconcile with prior Supreme Court decisions like *Central Bank of Denver* that have employed a literal approach in restricting the scope of Rule 10b-5 and similar private liability rights of action under the federal securities laws. Certainly, the "green" signal sent to the lower courts in *Gustafson* is a confusing one with far-reaching practical and jurisprudential implications.

Handbook Series No. 23, 1995) ("The words 'due diligence' do not appear in any of the federal securities laws .... The phrase 'due diligence' has been extrapolated from the procedures under the federal securities laws which provide defenses under both the Securities Act of 1933 and the Securities Exchange Act of 1934 . . . .").

189 Purchasers that have often become accustomed to receiving detailed disclosure documents will likely ask for them. In addition, they may seek express warranties and representations as an additional basis for recovery to protect their investment. *See, e.g.*, Jennifer Lachinski, *Bankers Say That They'll Continue to Obtain Due Diligence Opinions on Private Deals*, CORP. FINANCING WK., Sept. 4, 1995, at 1.

190 *See supra* notes 175–77.